OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: Deborah A. Butler
Assistant Chief Counsel (Field Service)
CC:DOM:FS

SUBJECT:

This Field Service Advice responds to your memorandum dated April 6, 1999 requesting reconsideration of a prior Field Service Advice issued April 14, 1995. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

LEGEND:

Authority =

City =
Conduit Borrower =

Series A =
Series B =
$a =
$b =
$c =

ISSUE:

Whether the sanctions imposed by I.R.C. § 150(b)(3) apply where bonds purported to be tax-exempt, but the bond-financed facility was never actually used in a manner qualifying for tax-exempt financing.

CONCLUSION:

I.R.C. § 150(b)(3) applies where bonds purported to be tax-exempt, but the bond-financed facility was never used in a permissible manner. The change in use relevant for application of section 150(b)(3) is a change in the purported use of the bond proceeds rather than a physical change in use.

FACTS:

Although the facts of the prior FSA are incorporated by reference, the most pertinent details are repeated below:

The Authority issued Series A bonds in the amount of $a. The City issued Series B bonds in the amount of $b. The proceeds from the Series A and Series B bonds (referred to collectively as the "Bonds") were loaned to the Conduit Borrower, an I.R.C. § 501(c)(3) organization. The Conduit Borrower used $c of the proceeds to purchase existing rental storage facilities that were leased to the general public. The financing documents state that interest on the Bonds is tax-exempt. You ask us to assume that the bond financed facility is used in an unrelated trade or business as defined in section 513.

LAW AND ANALYSIS:

Under I.R.C. § 103(a)[1], gross income does not include interest on a State or local bond. Section 103(b)(1) provides that section 103(a) does not apply to any private activity bond, unless it is a qualified bond under section 141. Section 141(e)(1) provides that qualified bonds include qualified 501(c)(3) bonds.

[1] All Code references are to the Internal Revenue Code of 1986 unless otherwise noted.

Section 145(a) provides that, except as otherwise provided in section 145, the term "qualified 501(c)(3) bond" means any private activity bond issued as part of an issue if–

> (1) all property which is to be provided by the net proceeds of the issue is to be owned by a 501(c)(3) organization or a governmental unit, and
>
> (2) such bond would not be a private activity bond if–
>
> > (A) 501(c)(3) organizations were treated as governmental units with respect to their activities which do not constitute unrelated trades or businesses, determined by applying section 513(a), and
> >
> > (B) paragraphs (1) and (2) of section 141(b) were applied by substituting "5 percent" for "10 percent" each place it appears and "net proceeds" for "proceeds" each place it appears.

Thus, the private activity bond rules set forth in section 141 are incorporated by reference in section 145, with certain modifications.

Section 150(b) provides for certain consequences where there is a change in use of facilities financed with bonds that purported to be tax-exempt private activity bonds when issued. Specifically, section 150(b)(3) provides that, in the case of any facility for which financing is provided from the proceeds of a bond which, when issued, purported to be a tax-exempt qualified 501(c)(3) bond, if any portion of such facility is used in a trade or business of any person other than a 501(c)(3) organization or a governmental unit, but continues to be owned by a 501(c)(3) organization, then the owner of that portion is treated as engaged in an unrelated trade or business (as defined in section 513) with respect to that portion. In addition, section 150(b)(3)(B) provides that no deduction is allowed for interest on financing described in section 150(b)(3)(A) which accrues during the period beginning on the date the facility is used in a trade or business of any person other than a 501(c)(3) organization or a governmental unit and ending on the date the facility is not so used. The legislative history of this section states that the consequences under section 150(b) of the Code "apply in addition to any loss of tax exemption." H.R.Conf.Rep. No. 841, 99th Cong., 2d Sess. 733 (1986), 1986-3 (Vol. 4) C.B. II-733.

You do not seek advice regarding the taxability of interest on the Bonds. Rather, your sole question is whether section 150(b)(3)(B) is applicable where bond proceeds finance a facility that, from the date of issuance, is never used in a manner qualifying for tax-exempt financing. In other words, does section

150(b)(3)(B) deny a deduction for interest where there is no physical "change in use" with respect to a bond-financed facility.

From the plain language of the statute, the sanctions imposed by section 150(b)(3) apply where bonds purported to be tax-exempt, but the financed facility is subsequently used impermissibly. As stated in the prior FSA, "[s]ection 150(b)(3)(A) describes a financing transaction involving bonds purported to be tax-exempt when issued and bond financed property, which, while owned by a 501(c)(3) organization, is used in a trade or business of a person other than a 501(c)(3) organization or a governmental unit." There is no language in the statute that suggests that a physical change in use of the bond-financed facility must occur before section 150(b)(3)(B) applies.

You have asked for clarification of the advice rendered in the prior FSA due to a concern that it contains a statement that may conflict with the rule enunciated above. Specifically, the statement in question states that "a change from a permissible use to an impermissible use is required for section 150(b)(3)(B)." Based on our discussion below, we do not believe that this statement is inconsistent with the overall conclusion reached in the prior FSA.

Rather than a change in physical use of the financed facility, the change in use contemplated in the prior FSA is the change from a purported tax-exempt purpose to a use not qualifying for tax-exempt financing. The prior FSA was not meant to imply that section 150(b)(3) requires the bond-financed facility to be physically used in a permissible manner and then changed to an impermissible use. If the Bonds purported to be tax-exempt at the time of issuance and the financed facility is subsequently used in a manner not qualifying for tax-exempt financing, section 150(b)(3)(B) applies. This is consistent with the conclusion of the prior FSA that "the statute only requires that the issuer expect at issuance that the bond will be tax-exempt; it does not require that the bond financed facility actually be used in a permissible use." Such interpretation is also supported by the legislative history of this section which states that "interest becomes nondeductible if property financed with the proceeds of the bonds is used in a manner not qualifying for tax-exempt financing at any time before the bonds are redeemed." S.Rep. No. 313, 99th Cong., 2d Sess. 851, 1986-3 (Vol. 3) C.B. 851.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

Our advice is limited to the narrow issue raised in your April 6, 1999 memorandum. Namely, whether section 150(b)(3)(B) requires an actual change from a permissible to impermissible use. As discussed herein, the statute only requires that the Bonds purported to be tax-exempt and the proceeds were subsequently used in an impermissible manner. This position is supported by the plain language and legislative history of the statute. [redacted]

[redacted]

Please call if you have any further questions.

By:

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CAROL P. NACHMAN
Special Counsel
Financial Institutions & Products Branch

cc: